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GUEST: D.C. Rao, Director
International Economics Department
World Bank

JOURNALISTS: Paul Lewis, The New York Times
Evgueni Menkes, TASS
Bhaskar Menon, PTI-TV, India

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SYNOPSIS

Coping with External Debt in Developing Countries

D.C. Rao, Director of the World Bank's International Economics Department, looks at the complicated task facing developing countries in repaying the 1.2 trillion dollars they have amassed in external debt. He points out that countries which are well organized domestically stand a better chance of negotiating a debt settlement, attracting more outside money and restoring momentum to their development plans.

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VOICE From United Nations Headquarters in New York, this is **WORLD CHRONICLE**, an unedited interview programme about major global issues. Here now to introduce our guest is the host of today's **WORLD CHRONICLE**.

LITTLEJOHNS: I'm Michael Littlejohns and this is **WORLD CHRONICLE**.

One of Charles Dickens' characters once declared than an annual income of 20 pounds accompanied by an annual expenditure of 19 pounds meant happiness, while an annual income of 20 pounds with an expenditure of even just a few pennies more brought misery. That same observation rather neatly summarizes one of the major economic challenges of the 1990s -- the external debt crisis of the developing countries. Debt has blocked economic growth for many of them; it's a major obstacle to revitalizing the global economy; and it has many political and social aspects beyond the obvious financial issues.

Today's guest is D.C. Rao, Director of the International Economics Department at the World Bank. He will be interviewed here at United Nations Headquarters in New York by: Paul Lewis of The New York Times; Evgueni Menkes of TASS; and Bhaskar Menon of PTI-TV of India.

Mr. Rao, welcome to **WORLD CHRONICLE**.

LITTLEJOHNS: Mr. Rao, I understand that the total external debt of the developing countries is something in the neighbourhood of $1.2 trillion which is an enormous sum of money, how did this large sum develop, how did this large debt

develop? Was it a matter of expectations being too high, both by the lenders and the borrowers, and how is it ever going to be repaid?

RAO: Well, it certainly wasn't developed overnight, it took several years. Development is something which requires a lot of money and the developing countries have a long way to catch up so over the years there has been a tremendous demand and obviously projects have also had a promise of very high rates of return, so there has always been an attraction to draw in resources from outside to finance development. The proportion of external resources has always been quite small but nonetheless, cumulated over the years, this has added up to quite a lot and over the years, as the international environment has deteriorated, it has become more difficult for developing countries to repay these obligations on time. There have been reschedulings and various kinds of other schemes to help the developing countries but one of the net results of this over the years was an accumulation of debt and in recent years there has been a recognition that this accumulation of debt cannot be serviced entirely on the original terms and there has been a lot of effort to help reduce this debt, first and foremost for the low income countries, the poorest countries that face the most severe problems of indebtedness, and more recently also for the middle income countries where there have been schemes to help reduce their debt.

LITTLEJOHNS: Has the money been used for development projects in the main -- infrastructure and so on?

RAO: In the main the money has been used for development but I think occasionally there have been over-optimistic expectations of the returns of these projects.

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Some countries have tended to use external debt to meet a savings deficit rather than rely adequately on their own domestic effort to mobilize savings and to the extent that there have been problems which have led to rescheduling, that has meant a postponement of the problem and a building up of debt service obligations that have made them more difficult to meet in the long run.

LITTLEJOHNS: Has the money, this large sum, $1.2 trillion, come mainly from governments or from the private sector or both?

RAO: Well, this has varied. For the middle income countries the overwhelming proportion has been from the private sector and the figure that you quote of external debt involves obligations to the multilateral institutions, to official creditors -- both governments and export credit agencies and commercial banks. For the middle income countries it's predominantly commercial banks, for the low income countries it's predominantly official creditors.

LEWIS: Can you tell us something about what the international community is doing about this problem? We seem to have a lot of plans. First of all we had a Baker Plan and now we have a Brady Plan named after Secretaries of the U.S. Treasury, now what is the Brady Plan? Is it working?

RAO: Well, let me step back first to the Baker Plan. As it was recognized that there was a substantial accumulation of debt, initially the expectation was that this was primarily a liquidity problem and providing more money would help reduce the problem. Gradually it was felt that this provision of more money in some cases was excessive and indeed something would have to be done to reduce the outstanding amount

of debt and this is where the Brady Initiative came in. Along with some other finance ministers, the Initiative was proposed in March of '89 and one of the elements of this, the main element of this, was that there would be a market-based negotiation between the debtor and the commercial creditors under certain parameters. The principal parameters were that the multilateral institutions -- the World Bank and the International Monetary Fund -- along with some bilateral governments, principally Japan, would provide special support for this exercise of debt and debt service reduction. The support would take the form of lending which could be used to collateralize various instruments or to buy back debt, commercial debt. The terms of the enterprise of the reduction of debt and debt service would be determined in a negotiating framework between the developing country, the debtor country and the commercial creditors and these terms would have to be settled between them, recognizing that there was official support available to enhance these instruments that would be made available to the commercial creditors in exchange for the original loans.

MENKES: If you could sum up everything what you've said, told us just before, is there any more light at the end of the tunnel? Do you consider that now we are closer to the settlement of this problem than say two, three years ago?

RAO: Let me answer this in two parts. For the low income countries there has been a recognition that substantial concessional assistance and write-offs of certain parts of their debt in some cases are necessary in order to help them sustain their development momentum. You've heard of the Toronto terms which involved a concessional rescheduling of official debt to the Paris Club. In addition, there have been proposals more recently to increase the degree of

concessionality to deal with the cases that are most severely indebted among the low income countries and through the IDA flows -- that's the concessional flows from the World Bank -- and other kinds of bilateral concessional flows, the attempt has been to make sure that the poor countries get adequate financing for their development needs. For the middle income countries, which is the other part of the problem that you raised, I think what recent events have shown is that you have a possibility of dealing with the debt overhang if there is a reasonably strong adjustment programme in the first place, domestically. We believe that to deal with the external debt problem in the middle income countries you really need three main elements: one is a strong domestic adjustment programme; second is a favourable international environment and a third is adequate external financing and what the negotiations under the Brady framework for Mexico, for Costa Rica and the Philippines have shown, is that if you have a strong domestic programme it is possible to reach a negotiated settlement to the debt which does improve the outlook for the country, does help them mobilize resources externally and does help restore some development momentum.

LITTLEJOHNS: Mr. Rao, so that we don't confuse our listeners and viewers, perhaps you should tell us what the Paris Club and IDA are?

RAO: I'm sorry about that. The Paris Club is a group of official creditors that meets periodically to reassess the debt repayment situation of developing countries owing debt to official export credit agencies.

LITTLEJOHNS: And IDA?

RAO: And IDA is the International Development Association which is the concessional arm of the World Bank which makes credits with 50 years maturity and a service charge of half a percent.

MENON: Mr. Rao, in following the debt crisis over the last decade as it's grown and mushroomed beyond control, it seems to me that we're using a lot of very polite words to describe what would essentially be loan sharking if it were happening on the street, would that description be accurate do you think of the relationship between the developing and the developed countries?

RAO: I don't believe so. I think these loans were undertaken with the full knowledge of the repayment obligations. The terms of these loans were not especially unreasonable. There were certainly times when the spreads that developing countries had to pay were somewhat higher but I would not subscribe to the notion that it would be called loan sharking. What has happened since has been that as the international environment has been relatively unfavourable as interest rates rose, the debt service obligations of these countries increased and as domestic adjustment policies were not put in place or were inadequate, the means to repay these debts were less available than had been forecast and which is why these problems have arisen.

MENON: May I ask a follow-up? What proportion, I mean from the original loans, how much of that do you think has been repaid or how many times has it been repaid in terms of interest so far?

RAO: I don't know how to interpret that question. In any loan that you take there is a grace period in interest to be paid and a final maturity which typically is amortized over several years. What happened some years ago was that principal repayments were difficult and this led to rescheduling of the principal and the main consequence of this rescheduling of the principal means that if you are obliged to pay an amortization installment on a certain date and you cannot do so, there's an agreement between the creditor and the debtor that this installment will be paid at some later date but in the meantime, the debtor has the use of these funds and it is only proper that the debtor be charged interest on the use of these funds in the interim. The implication of course is that the interest payments balloon over time because as the rescheduling takes place and the principal increases, and the interest on that principal increases -- and there is more recently a phenomenon where the interest has also been rescheduled so the debtor is paying interest on interest, and this naturally leads to substantial increases in debt service. But this is not to say that the debtor has not had the use of the funds in the meantime.

LEWIS: Could you tell us now to what extent is the debt crisis really the fault of developing countries themselves in the sense that they have misinvested this money, that they have invested in inefficient enterprises and projects, that they have spent it on the urban elite, that they have spent it on military hardware and all these things? Is it in fact to some extent their own fault?

RAO: Well, it's very hard Mr. Lewis in a situation like this to point fingers. The ability to repay debt is something which has many, many aspects to it and most important of all is the capacity of the developing country, the

debtor country, to generate the foreign exchange and the savings necessary to repay this debt. First, there has to be a generation of savings and the capacity to transform these savings into foreign exchange if the external debt has to be serviced. In the process of years there can be many problems that arise, some external and some internal. It's very difficult to apportion blame on this but let me make just one very basic point which is that when a debtor has taken on an obligation it is necessary that the debtor make every effort possible to meet this obligation and it's only in the extreme circumstance that some external assistance on top of what might be normally forthcoming is necessary.

LITTLEJOHNS: The programme is **WORLD CHRONICLE**. Our guest is D.C. Rao, Director of the International Economics Department at the World Bank.

MENKES: Mr. Rao, may I ask you to dwell upon the question of indebtedness of the Eastern European countries?

RAO: Well, I can say that we have had some relationship with some Eastern European countries in the World Bank -- Romania, Yugoslavia and Hungary -- for several years with Poland for some time and very recently Czechoslovakia and Bulgaria have joined the World Bank as well. The extent of our knowledge naturally is related to how long we have had dealings with these countries and the external debt situation of these countries varies enormously. Poland is an extremely severely indebted country. Poland's external debt, if I remember correctly, is about five times its exports which by any standards is a very high ratio. Rumania on the other hand has practically no external debt having repaid all its external debt recently and Yugoslavia and Hungary are somewhere in between, so the situation varies a lot. Looking ahead, it's necessary that

the external financing flows to these countries be adequate to meet their financing needs at a time when they're going through severe stress of change in the economic systems. For a while it will be primarily a stabilization problem where the external financing may not be so great, but very soon there will be a development issue in these countries where they will build up infrastructure and capital stock and also have to meet the very special problems that have arisen because of the Gulf Crisis, the oil price, as well as the dismantling of the CMEA.

LITTLEJOHNS: CMEA, what's that?

RAO: It's a trading arrangement of the East European countries and the Soviet Union whereby there were agreements to trade certain commodities at certain prices that were mutually agreed and with the dismantling of this arrangement you have now a situation where these trades have to take place at international market prices which means that you have very large increases in prices that have to be coped with.

MENKES: If I may follow up, a number of experts at the United Nations recently proposed the idea that it might be necessary to arrange for some kind of Marshall Plan for Eastern Europe, what do you think of it?

RAO: There's no question that the amounts involved are large. The costs of dealing with the CMEA problem I referred to and the oil price we estimate for the East European countries to be of the order of $15 billion over a three-year period which is approximately five percent of their gross national product. It's also true that initially, private flows to these countries is liable to be relatively scarce because the economic reform process is starting, there is a lot

of pain ahead and until the reform process has made some progress it's unlikely that private investment flows will be forthcoming.

MENON: Mr. Rao, looking at the situation of the developing countries, would you say that they have any hope at all of digging themselves out of this hole. The debt in most cases, especially in the highly indebted countries, is so large that no one thinks that it's possible to pay them off and just as you have plans like the Brady Plan for debt reduction and interest rate reduction along comes the Gulf Crisis which completely demolishes all the adjustment plans that were place, so looking at this scene do you have any hope at all?

RAO: Well, let me first make the point that among developing countries there are many that were never in this hole in the first place. These are countries that faced all the same problems as other countries but somehow managed, through good economic management, to avoid getting into a debt crisis. There are other countries that have made good progress in getting out of the debt crisis. Let me quote the example of Chile which, without a special Brady Initiative agreement, through the use of debt equity swaps and other kinds of debt conversion and buyback has actually eliminated about 40% of its external debt. There are other countries, primarily Mexico, which through a very sensible adjustment programme which has been sustained, has been able to reach agreement with its creditors and is now well on its way to restoring development momentum. So what is involved really is the ability to put together this package of an external environment which is not too unfavourable, a domestic adjustment programme that is strong and with this to get the support of external lenders as well.

LEWIS: Could you tell us something about this rather intriguing idea that countries should forgive developing nations their foreign debt if they take the same amount of money and spend it on environmental programmes in their own countries? Can you tell us a bit about that?

RAO: Well, the origin of this idea is an adaptation of the debt equity swap into something which is now called the debt nature swap which is basically, if there is a given expenditure in a country which is deemed to be environmentally good, one way to finance this expenditure would be to find external donors to provide some fraction of this money. And I say fraction because external money can be leveraged by using it to buy the external debt that is selling at a discount and thereby what the external donor has to pay is let us say forty cents on the dollar to buy external debt, and if the secondary market discount is forty cents what the country will gain is an extinction of debt worth one dollar and the agreement is that the country puts in one dollar's worth of local currency into its domestic programmes.

MENKES: Debt and developing countries, that's what we say usually but let me ask you debt and developed countries, how do you visualize this problem? Does the problem of debt have any result or any consequences for the developed world?

RAO: Let me say that there is nothing morally right or wrong about debt. What is really at issue is a question of whether there's a creditor who is willing to lend these resources to you and to hold the resulting financial instrument. For developing countries, over several years, this was the case and there were willing creditors and we speak of the debt problem only because there came a situation where commercial creditors were no longer willing to make these loans

available and were trying to get rid of the loans that they had. For the developed countries that problem has not arisen and hence one doesn't speak of a developed country debt problem. However, there is of course the problem, particularly in the United States, that the debt obligations are so large that interest payments have become a very significant issue in the fiscal balance of the United States and this is a problem that has to be dealt with.

MENON: I know that you've said earlier before the show that we can't really trust many of the figures that people bandy around but I've heard several different figures used for the transfer of resources out of developing countries to developed countries. I've heard the figure of $50 billion or $56 billion, I've heard someone say $39 billion or $36 billion, what is it and where is it coming from and where is it going to?

RAO: Well, one must first of all view this in net terms and if you permit me I'll say a little bit about the concepts involved because as you quite rightly mention I don't trust any of these figures terribly much. There is first of all the question of what the amortization of the debt is in relation to the flow of new lending, second there's the question of what the transfer is if, in addition to the amortization you add the interest payment and set that against the flows, thirdly you have the question of what the old flows would be, which is lending, direct foreign investment and grants and set that against the outflows of amortization and interest, and finally you have countries that engage in prepayments of debt because they're able to and this is often aggregated along with other countries that are in a situation where they are getting some net transfers, but not much, and the net result of that of course is a negative number which is why I'm very reluctant to get into a discussion of specific numbers on this, specially in a short space of time.

LEWIS: Can you say anything more about the real impact of the Gulf Crisis on the debt problem because these countries now are facing increased oil prices and they're facing a decline in remittances from their citizens working in that area?

RAO: Indeed that is a crisis which has made the resolution of the debt problem for several countries considerably more difficult. You have an immediate problem in some countries which have had the cessation of workers remittances and the need to repatriate these workers and to resettle them domestically, plus the fact of a higher oil price. Of course, nobody knows how long oil prices will remain high and if they do remain high the problem will be that much more serious but initially we still have this question of how to deal with the immediate impact and the countries that are already indebted or low income, and I have in mind especially the countries of the Indian subcontinent -- India, Bangladesh, Sri Lanka, the Philippines and Pakistan -- and the countries which are seriously affected by the problem of workers or service income such as Turkey and Poland. These are the countries that require assistance relatively rapidly.

LITTLEJOHNS: I saw in one of the U.N. reports that the population of the poor in Southern Asia, even at the end of this century, is likely to be somewhere in the neighbourhood of 350 million people, it doesn't seem that the lending programmes have helped these countries very much?

RAO: Well, it's a question of where you started from. I think one of the important things to recognize is that in South Asia there has been a decline in the percentage and the absolute numbers of poverty.

LITTLEJOHNS: I'm afraid that's where we have to finish, Mr. Rao. That's all the time we have. Thank you for joining us on this edition of **WORLD CHRONICLE**.

Our guest has been D.C. Rao, Director of the International Economics Department at the World Bank. He was interviewed here at United Nations Headquarters in New York by: Paul Lewis of The New York Times; Evgueni Menkes of TASS; and Bhaskar Menon of PTI-TV of India.

I'm Michael Littlejohns. Thank you for joining us. We invite you to be with us for the next edition of **WORLD CHRONICLE**.

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